Nos. 22,047 and 22,047-A

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MELVIN L. HAIR and ESTHER HAIR,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

RICHARD E. HAIR and NAOMI L. HAIR,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

Cases:

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OPINION BELOW

The memorandum opinion of the Tax Court (R. 88-98) is not officially reported.

JURISDICTION

These consolidated petitions for review (R. 108-116, 121-128) involve federal income taxes for the taxable years 1962 and 1963. On March 11, 1965, and May 25, 1965, the Commissioner of Internal Revenue mailed to taxpayers Richard E. and Naomi L. Hair notices of deficiency asserting deficiencies in the aggregate amount of $4,823.83. (R. 27-29, 30-32.) On the same dates the Commissioner of Internal Revenue mailed to taxpayers Melvin L. and Esther Hair notices of deficiency asserting deficiencies in the aggregate amount of $5,424.25. (R. 11-13, 14-16.) Within ninety days thereafter, on June 10, 1965, taxpayers filed a petition with the Tax Court for a redetermination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. On July 26, 1965, the Commissioner filed a motion to require the taxpayers to file separate and amended petitions. On August 2, 1965, the Tax Court, granting the Commissioner's motion, ordered the taxpayers to file separate and amended petitions. These amended petitions were filed on August 18, 1965. (R. 1-16, 17-32.) The decisions of the Tax Court were entered on April 3, 1967. (R. 105-106, 107.) The case is brought to this Court by petitions for review filed June 19, 1967 (R. 108-116, 121-128), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the District Court correctly ruled that payments received by the taxpayers of 15 cents per cubic yard of sand and gravel removed from their land were ordinary income subject to the depletion allowance, not capital gain from a sale as taxpayers contend.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

*   *   *   *   *

(6) Royalties;

*   *   *   *   *

(26 U.S.C. 1964 ed., Sec. 61.)

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) General Rule.--In the case of mines, oil and gas wells, other natural deposits, * * * there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

*   *   *   *   *

(26 U.S.C. 1964 ed., Sec. 611.)

SEC. 613. [as amended by Sec. 302(a), Public Debt and Tax Rate Extension Act of 1960, P.L. 86-564, 74 Stat. 290]. PERCENTAGE DEPLETION

(a) General Rule.--In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property * * *

(b) Percentage Depletion Rates.--The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

*   *   *   *   *

(5) 5 percent--

(A) gravel * * * and stone * * *;

*   *   *   *   *

(26 U.S.C. 1964 ed., Sec. 613.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.611-1 Allowance of deduction for depletion.

*   *   *   *   *

(b) Economic interest. (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. * * *

*   *   *   *   *

(26 C.F.R., Sec. 1.611-1.)

STATEMENT

The facts in this case, as stipulated by the parties and as found by the Tax Court (R. 88-98), are as follows:

Melvin L. Hair and Esther Hair, and Richard E. Hair and Naomi L. Hair, are husbands and wives. Melvin and Richard, who are both farmers, are brothers. On the death of their mother, Edith A. Hair, on October 23, 1954, Melvin and Richard (hereinafter "the taxpayers")[1/] became the owner of an undivided one-half interest in certain lands located in the State of Washington. Parts of these lands were suitable for farming and parts were considered to be wastelands. (R. 89-90.)

Some time after taxpayers became the owners of the above-mentioned lands, test borings which showed deposits of sand and gravel were conducted on the properties by the Curtis Construction Company (hereinafter "Curtis"). Curtis, a subcontractor on a dam project, had an agreement with the prime contractor under which he was to furnish all sand and gravel for construction of the south shore portion of the dam. (R. 90.)

1/ Esther Hair and Naomi L. Hair are parties to this litigation solely by virtue of filing joint returns with their husbands.

On April 11, 1962, taxpayers as "Seller" entered a written agreement with Curtis as "Purchaser".[2/] This agreement provided, inter alia (R. 90-91):

> That in consideration of the sum of Ten Dollars ($10.00), receipt of which is hereby acknowledged, and of the stipulations herein contained, and the payments to be made as hereinafter specified, the Seller hereby agrees to purchase from the seller, the following:
>
> All of the Sellers' right, title and interest in and to the sand and/or gravel situate upon the following described premises: * * *
>
> This agreement shall remain in full force and effect for such a time as shall be required to enable Purchaser to complete its contract with the Prime Contractor related to construction of Lower Monumental Dam on the Snake River under which contract Purchaser has agreed to furnish all sand and gravel for construction of the south shore portion of said Dam. It is estimated that performance of the said contract by Purchaser shall take approximately three (3) years from the date of this Agreement but that Purchaser shall, nevertheless, have the full time necessary to complete said contract. In the event of the abandonment of said contract by Purchaser, this contract shall be deemed terminated.

2/ The parties have stipulated that though the agreement denominates as "Seller" the "Edith A. Hair Estate", for reasons peculiar to local law, for purpose of the cause at bar, the persons therein described as "Seller" were, in reality, Melvin and Richard. Neither Melvin nor Richard had ever previously engaged in the business of selling or marketing sand and gravel. (R. 45, 90.)

> Purchaser agrees to pay unto Seller Fifteen Cents (15¢) per cubic yard of sand and/or gravel removed from the said lands of Seller pursuant to this Agreement. * * *

During the years 1962, 1963 and 1964, Curtis removed quantities of sand and made payments to taxpayers as required by their contract. In 1964 Curtis completed performance of its sub-contract on the dam project and abandoned the instant contract. In accordance with its terms, the agreement was deemed terminated and the right to exploit the unmined sand and gravel reverted to the taxpayers. (R. 91.)

On their returns for the years 1962 and 1963 taxpayers reported the payments received from Curtis as income from the sale of a capital asset, that is, as deferred payments from a sale in 1962 of the sand and gravel in place. The Commissioner, in his statutory notices of deficiency, determined that the amounts received under the contract represented ordinary income and not capital gain as reported. (R. 91.) Deficiencies were determined as follows (R. 88):

Taxpayer	Year	Amount
Melvin L. and Esther Hair	1962	$ 294.63
	1963	5,129.62
Richard E. and Naomi L. Hair	1962	351.72
	1963	4,472.11

Following receipt of the notices of deficiency taxpayers filed timely petitions in the Tax Court. (R. 41.) The Tax Court

held that the amounts taxpayers received from Curtis were properly taxable as ordinary income (R. 98) because the taxpayers retained an economic interest in the sand and gravel in place (R. 97). These timely petitions for review followed. (R. 108-116, 121-128.)

SUMMARY OF ARGUMENT

Taxpayers transferred the right to exploit sand and gravel deposits on their land to a construction company in consideration of $10 plus 15 cents per cubic yard of sand and gravel extracted and removed. The construction company was not obligated to mine or pay for any particular amount of materials. The Tax Court was clearly correct in ruling that the payments were depletable ordinary income to the taxpayers, not capital gain from a sale as they contend.

Under the "economic interest" concept evolved by the Supreme Court, the owner of a depletable capital interest in minerals in place retains that interest so long as he continues to look solely to income derived from extraction for a return of his capital. Thus a landowner who transfers operating rights in mineral deposits on his land for royalty payments dependent upon extraction has not effected a capital transaction; he has retained his "economic interest" and receives the payments as depletable ordinary income. The Supreme Court has so held, and has made it clear that the rule applies without regard to the kind of mineral involved or the form in which the transaction is cast.

Five Courts of Appeals have applied that rule to the type of transaction here involved. Their decisions squarely support the decision of the Tax Court in the instant case, and we submit that it should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY RULED THAT THE PAYMENTS DEPENDENT UPON EXTRACTION OF SAND AND GRAVEL WERE ORDINARY INCOME TO TAXPAYERS SUBJECT TO THE DEPLETION ALLOWANCE

A. Introduction

The sole issue in this case is whether the payments to taxpayers of 15 cents per cubic yard of sand and gravel removed were the capital proceeds of a sale, as the taxpayers contend (Br. 14), or ordinary income subject to the depletion allowance, as the Tax Court held (R. 98).

Taxpayers owned land on which deposits of sand and gravel were discovered. They transferred to Curtis the right to remove as much sand and gravel as Curtis needed to complete its subcontract on a dam project, over whatever period of time might be necessary to effect such removal. Curtis was not obligated to remove or pay for any particular quantity of materials; it was obligated only to make the nominal downpayment of $10 and thereafter to pay 15 cents per cubic yard for whatever amount of materials it actually extracted and removed. In the event that Curtis abandoned its subcontract on the dam project, its contract with the taxpayers was automatically terminated.

Notwithstanding the terminology of sale employed, the contract between taxpayers and Curtis did not constitute an outright sale of taxpayers' mineral deposits or any specific portion thereof; it reflected a leasing or licensing arrangement under which taxpayers received the cubic yardage payments as ordinary income subject to the depletion allowance.

B. The substance of the agreement is controlling for federal tax purposes, regardless of the terminology employed

Taxpayers contend (Br. 13 et seq.) that because their agreement with Curtis was couched in the terminology of a sale, and because they intended a sale, the transaction should be treated as a capital transaction. This contention is unsound.

The tax consequences of a transaction are determined by its substance, not its form. Gregory v. Helvering, 293 U.S. 465. More particularly, with respect to transfers of mineral rights, the Supreme Court held in Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 32:

> Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place. Palmer v. Bender, 287 U.S. 551, 557.

As the Court said earlier in Palmer v. Bender, 287 U.S. 551, 555-556:

> We look to the statute itself and to the decisions construing it to ascertain to

> what interests it is to be applied, and then to the particular interests secured to the two partnerships by the instruments in question to ascertain whether they come within the statutory provisions. The formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant.

With specific reference to retention or divestiture of a depletable "economic interest" by a transferor of mineral rights, the Court said that the question (p. 557) "does not depend upon his [the transferor's] retention of ownership or any other particular form of interest in the mineral content of the land", but solely upon whether or not he retains the requisite right to share in production, discussed below.

Nor are the tax consequences of taxpayers' agreement with Curtis affected by any subjective "intention" on the part of taxpayers to effect a "sale", i.e., to secure capital gains treatment rather than the lesser benefit of a 5 per cent depletion allowance. The Third Circuit recently held in Commissioner v. Danielson, 378 F. 2d 771, 775, certiorari denied, October 9, 1967, 36 U.S. Law Week 3142, that --

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.

Here the taxpayers do not suggest that they intended some other

arrangement with Curtis than that reflected in the terms of the agreement. They must, accordingly, abide by the tax consequences of the agreement as written and executed.

C. The controlling principles

Section 611(a) of the Internal Revenue Code of 1954, supra, allows as a deduction in computing taxable income, in the case of mines and other natural deposits, "a reasonable allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate". In the case of sand and gravel and allied materials, a percentage depletion deduction in the amount of five per cent of the gross income from the property was authorized by the statutory provision (Section 613(b)(5)(A), supra), applicable to the taxable years involved.

The depletion allowance "is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit", and "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired". Commissioner v. Southwest Expl. Co., 350 U.S. 308, 312. Accord, Anderson v. Helvering, 310 U.S. 404, 407-408; Parsons v. Smith, 359 U.S. 215, 220; United States v. Cannelton Sewer Pipe Co., 364 U.S. 76, 81; Paragon Coal Co. v. Commissioner, 380 U.S. 624, 626.

So long as the owner of a capital interest in minerals in place retains such interest, the depletion deduction is the only permissible way in which he may be compensated for the disposition,

through production, of his capital asset. He is not entitled to capital gain treatment of production income, whether he operates the property himself or, as lessor, receives a share of the production income in the form of royalties. This was settled at an early date in Burnet v. Harmel, 287 U.S. 103. There the Supreme Court considered the contention of a lessor of an oil and gas property that a lease bonus and royalties received under the lease were taxable as capital gain. Rejecting the contention, the Court held that taxing the bonus and royalties as ordinary income did not produce the hardship at which the capital gains provisions were directed, i.e., the realization and taxation in one year of a total appreciation in value which had taken place over a considerable period of time. The Court regarded it as immaterial for federal tax purposes that the lease, under local law, effected a transfer of title.

A month after Burnet v. Harmel was decided, the Supreme Court took the same view as to hard minerals in Bankers Coal Co. v. Burnet, 287 U.S. 308. There the taxpayer-lessor had transferred operating rights in coal deposits in consideration of a per ton royalty with an annual minimum royalty guaranteed. The taxpayer contended that the royalties were capital gain from a sale. The court again rejected this view of royalties paid under a mineral lease and, relying upon Burnet v. Harmel, supra, said (p. 311):

> The considerations which led to the conclusion that the bonus and royalties paid to the lessor of Texas oil lands are taxable income and not a conversion of capital, as upon a sale of capital assets, are equally applicable to West Virginia coal leases, whether the title to the coal in place passes to the lessee at the date of the lease, or only upon severance by the lessee.

Shortly after deciding Bankers Coal Co., supra, the Supreme Court enunciated the "economic interest" concept for the first time in Palmer v. Bender, 287 U.S. 551. This concept, fully consonant with the earlier decisions, embodied specific tests for determining whether, in a mineral transaction, a taxpayer has acquired or retained a depletable interest in minerals in place. The Court defined an "economic interest" (287 U.S., p. 557) in terms of two requirements which are set forth in current Treasury Regulations on Income Tax (1954 Code), Section 1.611-1(b)(1), supra, as follows:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place * * * and secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he must look for a return of his capital.

Under these requirements, it may be noted, it is immaterial whether the taxpayer has or retains the operating rights. Hence, a transfer of operating rights, as in the instant case, does not divest a taxpayer of his depletable economic interest. He retains that interest if he continues to "look solely to the extraction" of the mineral for a return of his capital. Commissioner v. Southwest Expl. Co., 350 U.S. 308, 314.

In Palmer v. Bender, 287 U.S. 551 the taxpayers, who owned oil and gas leasehold interests, transferred the operating rights for bonuses, royalties and production payments. The court held, as it had in Burnet v. Harmel and Bankers Coal Co., supra, that the considerations for the transfer were depletable ordinary income, not capital gain from a sale as the taxpayers contended.

Transactions which do and do not constitute sales have been contrasted by the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 35-36, as follows:

> * * * there must be a determination under federal tax law as to "whether the transferor has made an absolute sale or has retained" such economic interest as we have just described in the preceding paragraph. * * * We have said that the instrument should be construed as a sale when a large cash payment was made with a reserved payment that could be satisfied by future sales of the transferred property without extraction of the oil. Obviously, there could be no depletion without extraction. Anderson v. Helvering, 310 U.S. 404, 412. On the other hand, we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only, if, as and when produced," as the reservation of an economic interest * * * not a sale. Thomas v. Perkins, 301 U.S. 655.

Over the years, the Supreme Court has recognized that the requisite continuing dependence on extraction may take a variety of forms. Thus, it has recognized that an economic interest is retained where the payments are in cash rather than in kind, Helvering v. Twin Bell Syndicate, 293 U.S. 312; or constitute a percentage of gross production, Burnet v. Harmel, 287 U.S. 103; or

a percentage of the net profits, Burton-Sutton Oil Co. v. Commissioner, supra. And payment is deemed no less dependent upon extraction because the transferor receives an initial lump sum payment (or "bonus") in addition to the right to future royalties. Burnet v. Harmel, supra; Thomas v. Perkins, 301 U.S. 655.

Similarly, payments in a fixed amount per unit of minerals removed are depletable ordinary income, not capital gain, to a transferor of operating rights. Bankers Coal Co. v. Burnet, 287 U.S. 308. Twelve years after that decision, in Douglas v. Commissioner, 322 U.S. 275, the Supreme Court again dealt with a transfer of operating rights in hard minerals in consideration of a fixed royalty per ton with an annual minimum payment guaranteed. While the precise issue was the validity of Treasury Regulations requiring restoration of depletion deductions to basis in the absence of production, the Court recognized that the royalty payments clearly were depletable ordinary income to the transferor in the first instance.

In accord with the Supreme Court's decisions, five Courts of Appeals have recently held in cases involving hard minerals (usually sand and gravel) that payments in a fixed amount per unit of minerals removed were not capital gain from a sale but depletable ordinary income to the taxpayers, who had transferred the operating rights in consideration of such royalty payments.

Royalton Stone Corp. v. Commissioner, 379 F. 2d 298 (C.A. 2d), certiorari denied on December 5, 1967 (36 U.S. Law Week 3227); Wood v. United States, 377 F. 2d 300 (C.A. 5th), certiorari denied on December 5, 1967 (36 U.S. Law Week 3227); United States v. Peeler, 377 F. 2d 531 (C.A. 5th), certiorari denied on December 5, 1967 (36 U.S. Law Week 3227); United States v. Green, 377 F. 2d 550 (C.A. 5th), certiorari denied on December 5, 1967 (36 U.S. Law Week 3227); Schreiber v. United States, 382 F. 2d 553 (C.A. 7th); Freund v. United States, 367 F. 2d 776 (C.A. 7th); Rabiner v. Bacon, 373 F. 2d 537 (C.A. 8th); Laudenslager v. Commissioner, 305 F. 2d 686 (C.A. 3d), certiorari denied, 371 U.S. 947.

There is one appellate decision, Linehan v. Commissioner, 297 F. 2d 276 (C.A. 1st), which cannot be reconciled with the above-cited Supreme Court and appellate decisions. In Linehan the court held that a transfer of operating rights in hard minerals for royalty payments measured by quantity was a sale, reasoning that (p. 279) --

> the taxpayer had no "economic interest" in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters.

This rationale is in direct conflict with the Supreme Court's decision in Bankers Coal Co. v. Burnet, supra. It has not been adopted by any other appellate court. To the contrary, it has

been rejected by the Fifth Circuit in Wood, the Third Circuit in Laudenslager and the Eighth Circuit in Rabiner. And the Second Circuit ignored it in Royalton Stone, albeit the taxpayers in that case expressly relied upon Linehan.

The First Circuit's view that a taxpayer transfers his depletable interest in a capital transaction unless he retains his interest in the minerals "after severance", and shares in the proceeds or profits from the sale of the minerals, is clearly at odds with the Supreme Court's formulation and application of the "economic interest" concept. The test is whether the transferor has retained an "economic interest" in minerals in place (Palmer v. Bender, supra). And there is no requirement that the transferor share in the proceeds or profits from mineral sales; it is enough if the transferor "secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he must look for a return of his capital". (Emphasis supplied.) Treasury Regulations, Section 1.611-1(b)(1); Palmer v. Bender, supra, p. 557. As the Supreme Court reiterated in the more recent decision in Commissioner v. Southwest Expl. Co., supra, p. 314: "The second factor has been interpreted to mean that the taxpayer must look solely to the extraction of oil or gas for a return of his capital".

The First Circuit invoked Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, but that case did not purport to modify or extend the "economic interest" concept. The transferor in Kirby Petroleum did

indeed share in the profits of the transferee, through a retained <u>net profits</u> interest; and the Court held that a transferor retains his "economic interest" through retention of a net profits interest as well as through reservation of other forms of royalties. But the Court did not hold that the transferor must share in post-severance profits. Rather, the Court held (326 U.S. at p. 603):

> The test of the right to depletion is whether the taxpayer has a capital investment in the oil <u>in place</u> which is necessarily reduced as the oil is extracted. See <u>Anderson</u> v. <u>Helvering</u>, 310 U.S. 404, 407. [Emphasis supplied.]

<u>Linehan</u> was an unusual case on its facts. It involved an agreement to excavate a tract of raised elevation down to a specified grade, in preparation for industrial use of the property as so graded, and there is some indication that the First Circuit viewed the transaction as the completed sale of a specific total quantity of minerals. In any event, the rationale of the case is simply wrong.

D. <u>Taxpayers retained their "economic interest" and received the payments for minerals removed as depletable ordinary income</u>

As pointed out above, five Court of Appeals have recently held in cases involving a transfer of operating rights in hard minerals (usually sand and gravel) that payment of a fixed amount per unit of minerals removed, as consideration for the transfer, was ordinary income to the transferor subject to the depletion allowance -- the Second Circuit in <u>Royalton Stone Corp</u>. v.

Commissioner, supra; the Fifth Circuit in Wood v. United States, supra, and the companion Peeler and Green cases; the Seventh Circuit in Schreiber v. United States, supra, and Freund v. United States, supra; the Eighth Circuit in Rabiner v. Bacon, supra; and the Third Circuit in Laudenslager v. Commissioner, supra. These decisions have all made it clear that form was not controlling, and that the critical factor was the transferor's continuing dependence upon extraction for a return of his capital. As noted, the Supreme Court has denied the taxpayers' petitions for certiorari in Royalton Stone, Wood, Peeler, Green and Laudenslager.

The instant taxpayers, faced with the foregoing decisions, have devoted their brief largely to the contention that they are entitled to capital gain treatment under this Court's decision in Gowans v. Commissioner, 246 F. 2d 448, and cognate cases. Taxpayers' reliance is misplaced.

In Gowans the transferee of operating rights had both the right and the obligation to remove a specific total quantity of black sand from a designated deposit, during a fixed period, in consideration of a fixed total price, payable in any event. While the total purchase price was prorated over the period of extraction in payments measured by quantity, it was independent of extraction not only in the operating company's ultimate obligation to pay the whole amount but in the securing of this obligation by the company's

bank note for the total sum. On these particular facts, this Court held that the parties had effected a capital transaction, i.e., the outright sale of the designated quantity of sand for a fixed price. The Second Circuit reached the same result on similar facts in Barker v. Commissioner, 250 F. 2d 195 -- a decision which the same court has characterized and distinguished in Royalton Stone as one (379 F. 2d at p. 300) "where there was an obligation to pay no matter what the extent of the minerals extracted * * *."

The logic of Gowans and Barker is, of course, that the continuing dependence upon extraction which marks an "economic interest" is absent where a fixed quantity of minerals is sold for a fixed total price, payable in any event. The instant taxpayers invoke this logic repeatedly, asserting, for example, that (Br. 27): "Curtis agreed to pay petitioners a fixed amount over a fixed or ascertainable period of time for a fixed or ascertainable volume of materials removed from a specifically described body of land".[3/] These assertions simply do not accord with the substantive terms of the agreement involved.

3/ In another case pending before this Court which presents the same issue as the instant case (Alkire v. Riddell, No. 22,070), it is interesting to note that the taxpayers rely principally upon other arguments as, e.g., that the "economic interest" test is not applicable in sand and gravel cases.

Notwithstanding the general recitation at the beginning of the agreement that taxpayers were selling to Curtis "all" of the sand and gravel on their land, it is clear from the ensuing specific provisions that the contract was in fact an open-end arrangement. Curtis did not undertake to purchase any fixed (or even estimated) quantity of materials, much less to pay a fixed total price in any event. Curtis was obligated only to pay 15 cents per cubic yard for such sand and gravel as it might remove from taxpayers' land, in order to meet its needs for such materials under its subcontract on the dam. It does not appear in the agreement or elsewhere in the record that the parties knew, when they executed the contract, the amount of materials Curtis would need. And even if they had known, the fact would be immaterial. By its own terms the agreement would be automatically terminated if at any time and for any reason, Curtis abandoned its subcontract on the dam. But the plain fact is that no specific or estimated quantity of materials was conveyed by the agreement, and that when Curtis had completed its subcontract (if it did not abandon it) its right to exploit any unmined sand and gravel expired.

In short, the agreement was like the open-end contract in Royalton Stone, which was also cast in the form of a "sale", but which the Second Circuit held to be a mere leasing or licensing arrangement, saying (379 F. 2d at p. 300):

> There was no requirement that all the minerals be extracted and the agreements fixed no maximum or minimum amount which

> the corporations were to quarry. In fact the corporations had no affirmative duty to mine at all. They could terminate the quarrying at any time without any liability except to pay 20 cents a ton for the minerals already quarried. If the corporations failed or refused to quarry, the agreements provide for no obligation to pay any amount whatever.

So, here, Curtis had no affirmative duty to mine at all, and could terminate their operations at any time without any liability except to pay for the minerals already mined.

In view of the recent decisions of the Fifth and Eighth Circuits discussed above, little need be said with respect to earlier decisions in those circuits invoked by taxpayers, i.e., Crowell Land & Min. Corp. v. Commissioner, 242 F. 2d 864 (C.A. 5th), and Commissioner v. Remer, 260 F. 2d 337 (C.A. 8th). The Second Circuit in Royalton Stone distinguished Crowell as a case where a fixed purchase price was payable over a fixed period, regardless of the amount of minerals extracted. The Fifth Circuit itself, in Wood, disapproved of the emphasis in Crowell on the wording of the governing instrument as one of sale, and also disapproved of the earlier decision to the extent that it based capital gains treatment on the fact that per tonnage payments were involved. Similarly, the Eighth Circuit in Rabiner v. Bacon, supra, which squarely supports the instant decision, has limited Remer to its particular facts.

Finally, taxpayers' citation of United States v. White, 311 F. 2d 399 (C.A. 10th), is pointless. In White the Tenth Circuit

held only that a large lump sum down payment was capital gain. As to future royalties, the court said (p. 402): "We do not reach the question of whether the payments to be made from production amount to the reservation of an economic interest which would require a different tax treatment of the income from that source". If anything, this indicates a recognition that the "economic interest" concept would control the reserved question.

CONCLUSION

For the reasons states above, the decisions of the Tax Court were correct and should be affirmed.

Respectfully submitted,

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FEBRUARY, 1968.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _______ day of ______________________, 1968.

____

MARIAN HALLEY,
Attorney.